

BRANCH OIL & GAS CO.

IBLA 95-93, 95-215

Decided March 31, 1998

Appeals from Decisions of the Associate Director for Policy and Management Improvement, Minerals Management Service, affirming Demand Letters to pay additional royalties on onshore natural gas production. MMS-90-0235-O&G and MMS-90-0275-O&G.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

When there is no market for uncompressed natural gas at the wellhead and the initial purchaser gathers, compresses, and resells the gas, the royalty value of the gas produced from the lease must be based on the price received upon resale, with no deduction for the costs of conditioning the gas for resale.

APPEARANCES: Gary G. Broeder, Esq., Billings, Montana, for the Branch Oil & Gas Company; Sarah L. Inderbitzin, Esq., Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., and Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE KELLY

The Branch Oil and Gas Company (Branch) has appealed from two Decisions of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS).

In the first Decision (MMS-90-0235-O&G), dated August 23, 1994, MMS denied Branch's appeal from an April 12, 1990, Order of the Chief, Office of State and Tribal Program Support, Royalty Compliance Division, Denver, Colorado (Denver office), directing it to pay additional royalties in the amount of \$1,871.80 with respect to natural gas production from Federal oil and gas leases Nos. 053-021663-0 and 053-057374-0 situated in Toole County, Montana. The MMS concluded that Branch had improperly valued the natural gas for royalty purposes during the period from November 1, 1987, through August 31, 1989. Branch's appeal was docketed as IBLA 95-93.

In the second Decision (MMS-90-0275-O&G), dated November 10, 1994, MMS denied Branch's appeal from a March 20, 1990, Order of the Denver office directing it to pay additional royalties in the amount of \$12,504.31 with respect to natural gas production from Federal oil and gas leases Nos. 053-055314-0 and 053-021633-0 situated in Toole County, Montana. The MMS concluded that Branch had improperly valued the natural gas for royalty purposes during the period from March 1, 1984, through June 30, 1987 (Lease No. 053-055314-0), and May 1, 1985, through June 30, 1987 (Lease No. 053-021663-0). Branch's appeal was docketed as IBLA 95-215.

By Order dated May 30, 1995, we consolidated the two appeals.

All of the natural gas at issue was sold by Branch, the lease operator, at the wellhead in an uncompressed state to Aloe Ventures Gathering System (Aloe), under an April 15, 1979, "Gas Purchase Contract."

Aloe is a joint venture partnership formed by Branch and other operators; Branch does not have a controlling interest in Aloe. Aloe gathered the gas from the subject wells, compressed it, and sold it at its processing plant to the Montana Power Company (MPC), under a separate gas purchase contract.

The wells, gathering system, and plant are in the same oil and gas field. The MPC is not affiliated with Branch or Aloe.

In computing royalty, Branch based the value of the gas on the initial price paid under its contract with Aloe. That price was, in accordance with Section 1, Article VIII, of the Gas Purchase Contract, 72 percent of the Aloe/MPC contract price, with the remaining 28 percent retained by Aloe as reimbursement for the capital and operating costs it paid to gather and compress the gas. See Gas Purchase Contract at 26. Based on an audit performed by the State of Montana Department of Revenue under delegated authority, the Denver office concluded in its orders that Branch should have valued the gas according to the Aloe/MPC contract price, with no deduction for the costs of gathering and compressing the gas.

In its statement of reasons for appeal (SOR), Appellant argues that under 30 C.F.R. § 206.103 (1987) royalty is to be based on the reasonable market value of the production of gas at the wellhead, not on the resale price paid by MPC to Aloe. Appellant asserts that the gas was not compressed for purposes of the first sale to Aloe since compression was not necessary to place the gas in a marketable condition for such purposes. Moreover, Appellant avers that the price it received from Aloe was equal to or greater than the wellhead price being paid by MPC and others to any other producer for like quality gas produced in the same field.

Appellant further notes that the cases cited by MMS in its Decisions, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1991) and Shoshone Indian Tribe v. Hodel, 903 F.2d 784 (10th Cir. 1990), are inapposite since they involved compression costs incurred by a Federal lessee to place gas in a marketable condition for purposes of the first sale to its immediate purchaser.

Finally, Appellant asserts that MMS improperly extended the reach of the "Marketable Condition Rule," claiming that it "allows [MMS] to ignore the first sale at the wellhead as a market and use a second sale of the gas several miles away from the leases as the market to determine the wellhead value of the production for royalty purposes." (SOR, IBLA 95-93, at 5.) It asserts that this renders the Decisions arbitrary, capricious, an abuse of discretion, and contrary to the law as set forth in the applicable lease and regulatory provisions.

[1] It is well established that a Federal oil and gas lessee/operator is required to place natural gas produced from Federally-leased lands in a marketable condition at no cost to the Federal Government. Mesa Operating Limited Partnership v. U.S. Department of the Interior, 931 F.2d 318, 324-25 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992). This "Marketable Condition Rule" was in effect throughout the period of time at issue here.

See 30 C.F.R. §§ 206.106(b) (1987) and 206.152(i) (1990). Thus, where a lessee/operator incurs the costs of gathering, compressing, sweetening, dehydrating, or otherwise placing the produced gas in a marketable condition, and then sells the conditioned gas into its true market, the lessee/operator may not deduct those costs from the sales price or proceeds used to value the gas for royalty purposes. Shoshone Indian Tribe v. Hodel, 903 F.2d at 788; California Co. v. Udall, 296 F.2d at 386. Rather, the lessee/operator must value the gas according to the sales price or proceeds with no deduction for such costs; otherwise, the costs of placing the gas in a marketable condition will be borne in part by the Federal Government.

In the case at hand, Appellant did not directly incur the cost of conditioning the gas, but sold it to Aloe which gathered and compressed the gas, resold it to MPC, and then paid Appellant the resale price minus Aloe's costs of conditioning the gas. This arrangement does not change Appellant's obligation to bear the costs of conditioning the gas for sale.

See R.E. Yarbrough & Co., 122 IBLA 217, 218, 223 (1992). As stated by MMS:

[B]y accepting a lower price for its gas, Branch in effect 'paid' Aloe to gather and compress the gas and excluded those costs from its royalty value. Under MMS regulations and case law, \* \* \* Branch has the obligation to put its product into marketable condition and the associated costs cannot be subtracted from royalty value.

(Answer, IBLA 95-93, at 5.)

We reject Appellant's argument that the first sale to Aloe reflects the true market value of the gas. First, Appellant has admitted that there was no market for the uncompressed gas at the wellhead. (SOR, IBLA 95-215, at 1-2.) Second, a market for uncompressed gas can be said to exist only where there is an "established demand" for that gas. California Co. v. Udall, 296 F.2d at 388. The fact that the uncompressed gas here was actually sold at the wellhead does not prove that there was a "market" at that point. See Texaco Inc., 134 IBLA 109, 115 (1995). Aloe cannot represent

that an established demand for that gas existed when the evidence shows that Appellant and others created Aloe for the specific purpose of buying and then marketing what was otherwise unmarketable gas. See Xeno, Inc., 134 IBLA 172, 183 (1995). Further, even after Aloe was created, the fact that the gas had, under the Branch/Aloe contract, no value until it was sold to MPC, is indicative of the fact that no market for the gas existed at the wellhead. See R.E. Yarbrough & Co., 122 IBLA at 223. Also, the fact that Appellant effectively paid for compressing the gas by accepting a price reduced by the costs of compression indicates that the gas was marketable in its compressed, but not its uncompressed, state. See Texaco Inc., 134 IBLA at 114-15.

Accordingly, we conclude that the resale of gas to MPC represented the first true market sale and that Appellant was required to use the price received from that resale for royalty purposes.

Up to this point, we have focused on the majority of the gas at issue here, which was produced prior to the March 1, 1988, effective date of the Department's current product valuation regulations. However, MMS' August 1994 Decision also pertains, in part, to production from Federal leases Nos. 053-021663-0 and 053-057374-0, which occurred between March 1, 1988, and August 31, 1989.

Current regulations clearly provide that, in using the sales price or proceeds received by a lessee to value its gas for royalty purposes, "that value shall be increased to the extent that gross proceeds have been reduced because the purchaser \* \* \* is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition." 30 C.F.R. § 206.152(i) (1990). Thus, the lessee may not transfer the burden of placing its gas in a marketable condition to a third party and then value it for royalty purposes by using the reduced sales price or proceeds paid by that party. Instead, those costs must be added to the sales price or proceeds.

Natural gas is deemed to be in a "marketable condition" when it is "sufficiently free from impurities and otherwise in a condition that [it] will be accepted by a purchaser under a sales contract typical for the \* \* \* area," which is the geographic region in which the gas has similar quality, economic, and legal characteristics. 30 C.F.R. § 206.151 (1990).

In the present case, there is no question that the subject gas was not accepted in its uncompressed state under a sales contract typical for the area. Appellant identifies MPC as the purchaser of more than 80 percent of the wellhead gas in the area. However, MPC would only accept Appellant's gas once it had been compressed. While Aloe would purchase the gas in its uncompressed state, it was an entity created by Appellant and others for the express purpose of buying gas from them. Therefore, we conclude that MPC, not Aloe, represented the purchaser under a typical area sales contract. Thus, compressing the gas was clearly necessary to place it in a "marketable condition," within the meaning of 30 C.F.R. § 206.151 (1990).

Finally, there is no question that the sales price received by Appellant from Aloe was "reduced" by the amount of the costs of compressing the gas paid by Aloe. 30 C.F.R. § 206.152(i) (1990). Thus, we conclude that Appellant was required by 30 C.F.R. § 206.152(i) (1990), after March 1, 1988, to increase that sales price by the amount of those costs, in order to properly value the gas for royalty purposes.

To the extent Appellant has raised arguments not addressed herein, they have been considered and rejected.

Therefore, we conclude that MMS' Decisions of August and November 1994, properly denied Appellant's appeals from the March and April 1990 Denver office orders requiring it to pay additional royalties based on the price received from the resale of the gas to MPC, with no deduction for the cost of gathering and compressing the gas for the purpose of that resale.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decisions appealed from are affirmed.

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John H. Kelly  
Administrative Judge

I concur:

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T. Britt Price  
Administrative Judge